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REMARKS

cc: David Low
[redacted]

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[redacted] letter and 2 articles XXXXXXXXX
Brazil:
"Economic Presentations at the Bank Advisory Committee Meeting" and
Argentina:
Talk by President Alfonsin and Meeting of the Bank Working Committee

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April 8, 1985

Mr. David Low
Room 7 E 47
Central Intelligence Agency
Washington, D. C. 20505

Dear Mr. Low:

I am enclosing copies of two memoranda. One summarizes comments to the Bank Advisory Committee by Antonio Carlos Lemgruber, President of the Central Bank of Brazil. The other sets forth comments at a meeting of the Bank Working Committee on Argentina by Minister of Economy Sourrouille of that country, as well as a representative of the IMF. These were prepared by a member of the Economic Sub-Committees for the two countries.

I also reviewed the current position of the Banks with Chile, Peru, Venezuela and Colombia. As you know, the Banks are now discussing a new program with Chile. A major problem continues to be disagreement on the amount of new money the Banks well provide. Chile is requesting $1156 million. The Banks countered with an offer of $400 million, but are likely to go to $600 million and perhaps in the end to $700 million for the next several years. It is believed non-bank sources should be able to meet Chile's needs thereafter. The World Bank in particular should be able to expand its program. Meanwhile, the Chilean economy continues to exhibit little or no growth under the tighter policies adopted after mid-1984.

With regard to Peru, the Banks expect to enter negotiations on a new program after the forthcoming elections. Peru continues to pay $50 million interest each month on existing debt to the Banks, but is six months in arrears.

Negotiations with Venezuela have been at a standstill recently. Venezuela is preparing a policy paper on the future handling of private-sector debt. However, the Banks are now receiving an increased flow of interest payments on private debt.

Colombia has not yet formally approached the Banks for financing. A meeting currently is set for the week of April 16. The Banks continue to be unanimous in their judgement that Colombia should reach an agreement with the IMF - a procedure which the President of Colombia resists. So an impasse may loom.

Sincerely,

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April 2, 1985

BRAZIL

Economic Presentations at the Bank Advisory Committee Meeting

Antonio Carlos Lemgruber, President of the Central Bank of Brazil provided an economic briefing to the Brazil Bank Advisory Committee meeting of April 1, 1985. Accompanying him were Sergio de Freitas, Director of the Central Bank's International Division and other Central Bank economic officials.

High Inflation. Mr. Lemgruber was quite direct in stating that Brazil's recent inflation rate is a "terrible" starting point for the new Government that took office on March 15, 1985. For the first quarter of 1985, inflation was at a record high of 11.8% per month or 284% annualized. However, Lemgruber expects inflation to decline and hopes that the April rate will be below 10% and that by end-year it might fall to 180% on an annual basis. The reason for this good expectation is an assumption that new fiscal restrictions being taken will reduce money expansion and this will cut inflation.

Economic Growth. The real economy is continuing to exhibit a good momentum in terms of production, sales and employment. In January of 1985, for example, industrial production was expanding at a 8% annual rate. Agricultural output is being paced by good crops of cotton, cocoa and soybeans. However, the currently strong expansion will likely be checked by the fiscal restrictions and real GDP for the year 1985 could be down to 3% from last year's 4.4% real GDP gain. A recession is not foreseen in 1985 despite the "austerity" of monetary and fiscal policies because the inflation decline would have a positive reaction on economic expectations.

Monetary Explosion. Lemgruber cited the "explosion" of money as another negative element in the economy. In December 1984 the monetary base grew by a large 36% for the month and by February 1985, the twelve-month expansion was at 267%. This had an obviously strong impact on rising prices. By mid-March 1985 (the time the new Government took office) the Central Bank undertook restrictive money market operations through sales of short-term Government securities and the increase of reserve requirements. As of mid-march the monetary base expansion was down to 247% annual rate and Lemgruber hopes for a further strong decline to a monthly rate of 20% in April.

Fiscal Restraints. The main burden of restrictive policies is being placed on the Government sector. Among the new measures being implemented are a 10% cut in Federal Government spending, a freeze on employment, and a prohibition of further lending by Government banks except for exports. The aim of these measures is to further reduce the nominal public deficit, which reflects inflation and

monetary-exchange rate indexing. The inflation-adjusted "operational" public sector position would be expected to show a larger surplus in 1985 as a result of the fiscal restraints. Control of the public sector nominal deficit is crucial to inflation control because the assumption is that the monetary accommodation of the fiscal imbalance quickly leads to higher prices.

Higher Interest Rates. Because of money supply restraints, interest rates for a time will be high in real terms until the Government deficit is reduced. With a lower deficit the Central Bank would not pressure interest rates since it would not have to sell as large a volume of securities. Funds freed by the limits on government bank lending will be used to buy government securities. Lemgruber noted the conflict between savers and investors with respect to interest rates. High and positive rates are an incentive to savers but present difficulties to borrowers. The aim of policy is to differentiate rates between borrowers and lenders, keeping them lower for borrowers and higher for lenders. How this is to be done was not explained.

Neutral Wage Policy. In response to a question, Lemgruber said that the intention on wages is to keep them equal to inflation. He described this as a neutral wage policy but said that this issue will be an important element in formulating a new program with the IMF. He does not want to rely on wages an an anti-inflation element, preferring to use monetary-fiscal restraints instead.

Monetary Correction Revised. Lemgruber briefly described a change in the system of monetary correction. Under the old rule, correction was based on inflation expectations while in the new rule it is based on recent inflation. This would tend to provide more certainty to the market. Lemgruber affirmed that the formula would still call for the relationship to hold as follows:

Monetary correction = inflation rate = devaluation rate

Noting the devaluation rate, Lemgruber stated that the policy is to maintain as realistic exchange rate as possible. Changes in the currency rate will be made on a daily basis and will be known by exporters at the beginning of each month. A daily mini-devaluation schedule has already been made public for the month of April. Lemgruber admitted that because of the cruzeiro's link to the U.S. dollar, there is a problem of over-evaluation. Switch to a market basket definition of the cruzeiro would reduce the over-valuation but it would also be too inflationary for Brazil. For the time being, the present foreign exchange system of equality between inflation and devaluation will be maintained.

Smaller Trade Surplus. In the balance of payments projections presented to the Advisory Committee in February, the previous Government projected a trade surplus of $12.9 billion for 1985. However, the evidence of trade transactions during the first quarter of 1985 has been disappointing with an only $1.8 billion surplus for the period. This is composed of $5.0 billion of exports and $3.2

billion of imports. Based on this trend, Lemgruber is now projecting a lower $11.0 billion trade surplus for 1985. The services accounts, particularly interest, are doing better than expected by about $500 million in the first quarter. Consequently, the revised current account projection is for a $2.0 billion deficit in 1985 in place of the previous $1.5 billion shortfall.

<u>No New Money</u>. Under the provisions of refinance worked out between the previous Government and the Advisory Committee, Brazil would have no new money needs from the commercial banks during 1985-1986. The details of this refinance and new money requirements are shown in the attached table, taken from my memorandum on Brazil of February 1, 1985.

As can be seen, if the new current account deficit is $2.0 billion instead of $1.5 billion, Brazil still would not need new money because there is a considerable $1.8 billion reserves increase assumption built in these projections. Indeed, Lemgruber indicated that the change in international reserves might be flat between 1984 and 1985 so a further trade shortfall could be made up from the reserves increase cushion. He also indicated that new money from non-commercial banks would be $5.0 billion in 1985, just about the level shown in the attached table. Lemgruber also added that he was satisfied with the preliminary refinance terms of a 16-year refinance of the 1985-1991 bank amortizations previously worked out with the Advisory Committee.

Beyond 1985, Lemgruber cited a number of positive external assumptions that should help Brazil maintain its position of trade surplus. These factors include good economic growth in the industrial countries, some improvement in commodity prices, some decline of interest rates, moderate oil import prices, and depreciation of the U.S. dollar. If any of these items becomes negative it would amount to a "shock" for Brazil and could upset the favorable balance of payments projections used in the refinance scenario.

<u>Status of IMF negotiations</u>. Lemgruber outlined the new phase of negotiations with the IMF after the Fund suspended its disbursements for failure to meet end-1984 targets. A group of IMF economists are in Brazil as of April 1 and will remain there for two weeks in a pre-negotiation phase. Lemgruber and his team are meeting with IMF Managing Director J. de Larosiere on April 2. By April 15 the IMF should prepare a pre-liminary assessment of Brazilian economic conditions and the start of negotiations on a new program should take place during April 22-29.

According to Lemgruber, the failure to meet the IMF's 1984 targets was an embarrasment to Brazil and he does not want a repeat of this experience. Thus, he is going to insist on realistic new 1985 targets rather than signing an agreement that would fail if the ceilings and limits were perceived to be non-attainable in advance. There is a suggestion of protracted negotiations in his statement to

the Committee: "We will fight for realistic targets!" For example, he cited the previous IMF targets for end-1985 -- 120% inflation and 60% money base growth -- as clearly un-reachable. He also hopes to shift the IMF testing period from June 1985 to June 1986 rather than the December period. Brazil traditionally goes through a holiday spurt of spending in December so this may be an effort to remove the significance of end-year performance, although the IMF would still have quarterly targets. On another IMF point, Lemgruber said that the practice of IMF "monitoring" was politically sensitive in Brazil and that a more neutral terminology such as "enhanced consultations" might be more preferable.

The expected schedule is for a completion of the IMF negotiations by the second week of May 1985 and to resume negotiations with the Bank Advisory Committee in the first week of May.

BRAZIL

Table 2. Gross New Money Requirements After Multiyear Refinancing[1]

(Million U.S. Dollars)

	Current Account Deficit (+)	Reserves Increase (+)	Bank Amortizations[1] (+)	Non-Bank Amortizations[2] (+)	Non-Bank Financial Inflows[3] (-)	Gross New Money Requirements (=)
1985	1,550	1,832	227	1,711	5,324	-4
1986	2,331	(593)	454	2,417	4,670	-61
1987	1,978	(300)	680	3,257	5,118	497
1988	1,742	312	907	3,526	5,645	842
1989	1,794	578	1,988	4,652	6,270	2,742
1990	2,117	711	2,405	4,815	6,956	3,092
1991	2,951	762	2,406	4,917	7,609	3,427

[1] The Refinance Terms for the Bank Amortizations Are:

Tenor (Years) = 16
Window (Years) = 7 (1985-1991)
Grace = Variable Amortizations

These terms are those agreed to by the Advisory Committee as of January 7, 1985. They also include an assumption that interest on rescheduled bank debt is calculated on a serial (year-by-year) basis rather than on a carve-out (7-year total) basis.

[2] Amortizations to Multilaterals, Bilaterals, Suppliers, IMF.
[3] Inflows From " " " ".

March 26, 1985

ARGENTINA

Talk by President Alfonsin and Meeting of the Bank Working Committee

President Raul Alfonsin of Argentina and his top officials were in New York during the week of March 18 and used the occasion to present some statements on the country's political and economic situation.

Speaking at an Americas Society luncheon on March 21, President Alfonsin characterized his election in December 1983 as marking the transition from authoritarianism "inertia" to "dynamic" democracy. He said fifty years of political instability preceded this change of government and his election should be understood as a system change as well.

President Alfonsin stated that he inherited a catastrophic economic situation in which speculative activity was dominant. The previous government failed to meet its own goals, particularly the emphasis on the private sector, and accumulated a huge external debt that produced neither economic growth or investment. Inflation was the second highest in the world (after Bolivia) and the level of real GDP per capita was 15% lower than in 1975.

Turning to his record in office, President Alfonsin indicated that it has been a mixed pattern of successes and failures. On the positive side, the fiscal deficit to GDP ratio has been reduced from 16.5% in 1983 to 8.5% in 1984 and the target is 5% in 1985. The foreign trade surplus achieved in 1984 was equivalent to 6.5% of GDP while economic growth was also positive by 2%. Inflation, however, was not a success and the President affirmed that anti-inflation efforts are a priority for his current economic program. Speaking about the external debt, the President said that the negotiations should not impede economic growth since this would not help either debtors or creditors. He hopes that 1985 will be another year of economic recuperation. Completing the description of the economic program the President listed the following eight goals on a priority basis:

1. A better distribution of income
2. To continue the anti-inflation fight
3. Reform of the tax system
4. Improving the financial system
5. Cutting the fiscal deficit
6. Expansion of the private sector
7. Expansion of exports
8. Increased attraction of foreign investment
9. Stimulate savings flows to productive and social sectors

It may be of significance that income redistribution was offerred as the highest priority among the President's goals.

Working Committee Meeting. A meeting of the Working Committee on Argentina was scheduled for the same day as the President's talk. Accompanying the Presidential party were Juan Sourrouille, the new Minister of Economy and Mario Brodersohn, Chief Debt Negotiator and President of the Argentine National Development Bank. These two officials met with the Working Committee on March 21 following a report made to the Committee by Richard Erb, Deputy Managing Director of the IMF.

The IMF. Mr. Erb provided details on the reformulation of the IMF program for 1985 and 1986. The IMF's delay in providing the March 1985, second disbursement in its $1.4 billion standby is related to the Argentine failure to meet end-1984 targets and limits on fiscal and monetary ceilings set out in the Memorandum of Understanding. An IMF mission is being sent to Buenos Aires in the week of March 25 to obtain a full assessment of the current economic situation. The key concern is the much-higher-than-anticipated inflation which led to breaching of the nominal peso limits on the cash deficit of the nonfinancial public sector and Treasury outlays. What the IMF would want now are understandings on the policies needed to bring down inflation. As soon as a new agreement can be obtained, the IMF staff would evaluate the program in light of at least two months of actual economic performance. Subject to good performance, a recommendation for the new program could be sent to the IMF Board around June-July 1985.

Although the IMF program was not observed in the fiscal and monetary sector targets and ceilings, Argentina did meet the external targets on reserves, arrears and external debt. Consequently, the IMF staff believes that the external part of the Argentine program is valid and that commercial bank new money needs for 1984-85 are still $4.2 billion -- the figure agreed to on December 2, 1984. There may be a need to undertake somewhat more domestic adjustment and move the exchange rate more rapidly in order to keep the $4.2 billion financial requirement intact. Any relaxation of the $4.2 billion should be avoided because of the difficulties of obtaining greater new money needs from the banks. Erb would thus like for the banks to complete their support program on a contingency basis while the IMF proceeds to reformulate the internal economic program. Beyond 1985, the IMF would prefer that Argentina should reduce its current account deficit so that no net new money would be required from the commercial banks in 1986.

The Minister of Economy. Minister of Economy Sourrouille repeated Mr. Erb's description of the Argentina IMF program at end-1984. He said the Government had met goals with respect to external variables but discrepancies were evident in the domestic criteria, especially the quasi-fiscal deficit of the central bank. The inflation rate has clearly departed from the implicit targets embodied in the IMF program for the public sector, and in the first quarter of 1985 has been much higher than projected. A new IMF mission is going to

Argentina to review the 1985 program and during April-May the Government will work on a new agreement. If all goes well, there could be two IMF disbursements at mid-1985 based on performance criteria related to December 1984 and March 1985 targets. Presumably, disbursements would be keyed to actual performance plus new understandings that would be reached in the current negotiations. Minister Sourrouille hinted at some disagreements with the IMF on the use of inflation-adjusted measures of nominal domestic targets. He said these nominal domestic targets, subjected to high and erratic inflation, jeopardize the commercial bank agreements despite the fact the external goals have been met. He suggested this difficulty could be avoided in the future but he did not indicate how inflation could possibly be disregarded in an IMF program. Sourrouille tried to assure the banks that interest payments will be maintained but added that the low level of reserves preclude "...promises we can't fulfill".

Mr. Brodersohn, the Chief Debt Negotiator, indicated that he would like to complete negotiations with the Working Committee as soon as possible. The immediate task ahead is to complete the IMF negotiations in order for bank disbursements to be made in line with Fund disbursements.

Evaluation. The main task ahead for Argentina is to correct the economy's internal imbalance so as to arrest the hyper-inflationary spiral. Despite statements by the IMF and the Government that the external part of the economy is performing well, there is a linkage between the internal and external sectors. Failure to correct the internal problems could affect the external sector through the demand for imports and the propensity for capital flight. In turn, such failure could increase the balance of payments gap and add to the $4.2 billion funding that is to be provided by international commercial banks. What needs to be done is to use the exchange rate depreciation more vigoursly while intensifying monetary-fiscal restraints. This could lead to little or no growth of the economy for 1985 and could impede the President's desire for economic recuperation. But there is little choice left to the Argentine authorities other than to proceed on new understandings with the IMF.